



DRAFT 2007-SVxz-18: IRC Update

BILL ANALYSIS

Committee: Revenue Laws Study Committee
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SUMMARY: *This proposal would update from January 1, 2007, to May 1, 2008, the reference to the Internal Revenue Code used in defining and determining certain State tax provisions. By doing so, North Carolina would conform to changes made by three federal acts, except that the bill would delay the impact of the bonus depreciation provision authorized by the Economic Stimulus Act. The bill would become effective for taxable years beginning on or after January 1, 2008.*

CURRENT LAW: North Carolina's tax law tracks many provisions of the federal Internal Revenue Code by reference to the Code.¹ The General Assembly determines each year whether to update its reference to the Internal Revenue Code.² Updating the Internal Revenue Code reference makes recent amendments to the Code applicable to the State to the extent that State law tracks federal law. The General Assembly's decision whether to conform to federal changes is based on the fiscal, practical, and policy implications of the federal changes and is normally enacted in the following year, rather than in the same year the federal changes are made. The current reference date is January 1, 2007.

BILL ANALYSIS: The proposal would change the reference date to May 1, 2008. By changing the reference date to May 1, 2008, the bill effectively incorporates into our State tax laws changes made by three federal acts, with one exception. The Economic Stimulus Act of 2008 (ESA) has three major components, only two of which impact State revenues: the 50% bonus depreciation provision and the increased expensing limit. The bill conforms to the increased expensing limit but delays the impact of the bonus depreciation provision. Additional detail on the nonconforming provision is provided below. The three federal acts are as follows:

- Economic Stimulus Act of 2008
- Mortgage Forgiveness Debt Relief Act of 2007
- Small Business and Work Opportunity Tax Act of 2007

Economic Stimulus Act of 2008

Enacted on February 13, 2008, the Economic Stimulus Act of 2008 (P.L. 110-185) is a \$152 billion package designed to stimulate the economy through rebates for individual taxpayers and incentives for businesses. The rebates, which are technically "advance credit payments," do not impact State revenues and are not discussed in this analysis. The three business incentives are the 50% bonus depreciation provision for qualifying property placed in service in 2008, the increased limits for section 179

¹ North Carolina first began referencing the Internal Revenue Code in 1967, the year it changed its taxation of corporate income to a percentage of federal taxable income.

² The North Carolina Constitution imposes an obstacle to a statute that automatically adopts any changes in federal tax law. Article V, Section 2(1) of the Constitution provides in pertinent part that the "power of taxation ... shall never be surrendered, suspended, or contracted away." Relying on this provision, the North Carolina court decisions on delegation of legislative power to administrative agencies, and an analysis of the few federal cases on this issue, the Attorney General's Office concluded in a memorandum issued in 1977 to the Director of the Tax Research Division of the Department of Revenue that a "statute which adopts by reference future amendments to the Internal Revenue Code would ... be invalidated as an unconstitutional delegation of legislative power."

expensing of qualified property in 2008, and increased depreciation limits for "luxury" autos predominantly used for business.

50% Bonus Depreciation Provision. – Depreciation is an income tax deduction that allows a taxpayer to recover the cost or other basis of certain property over several years. It is an annual allowance for the wear and tear, deterioration, or obsolescence of the property. Bonus depreciation allows a business to claim more of a deduction up front and spread the remainder out over the normal depreciation schedule. In other words, a taxpayer will recover the basis in the asset sooner than under prior law. However, over the life of the asset the taxpayer still receives the same benefit. Congress has used bonus depreciation several times to encourage business investment, specifically after September 11, 2001. The Jobs Creation and Worker Assistance Act of 2002 provided a 30% bonus depreciation allowance. The Jobs and Growth Tax Relief Reconciliation Act of 2003 extended the sunset and increased the amount to 50%.

Under the ESA, a taxpayer is entitled to depreciate in the first year 50% of the adjusted basis of certain qualified property placed in service during the 2008 calendar year.³ To be eligible to claim bonus depreciation, property must be (1) eligible for the modified accelerated cost recovery system (MACRS) with a depreciation of 20 years or less; (2) water utility property; (3) off-the-shelf computer software; or (4) qualified leasehold property. Bonus depreciation is available for every item of tangible personal property, except inventory, property used outside the U.S., and property depreciated under the alternative depreciation system. Other than the computer software mentioned, it is not available for intangibles. If property is sold in the same year it is placed in service, no bonus depreciation is allowed.

► **BILL ANALYSIS:** The bill does not conform State law to the accelerated depreciation schedule allowed under the ESA. Over the life of an asset placed in service during 2008, taxpayers will be able to deduct the same amount of the asset's basis under both federal and State law; it is just that the timing of the deduction will differ. To accomplish this "decoupling" from the federal accelerated depreciation provision, the bill does two things:

- The taxpayer must add back to federal taxable income 85% of the accelerated depreciation amount (50%) in the year the accelerated depreciation is claimed for federal purposes. The add-back means that for State tax purposes, a taxpayer would deduct less in that tax year than the taxpayer would have deducted if the State conformed to the accelerated depreciation law.
- In tax years beginning on or after January 1, 2009, the taxpayer may deduct from federal taxable income the total amount of the add-back required for either the 2007 or 2008 tax year, divided into five equal installments. This means that for State tax purposes, a taxpayer would be allowed to deduct a greater depreciation amount in the outlying tax years – the normal depreciation amount plus 20% of the accelerated depreciation amount the taxpayer had to add back. The purpose of this recovery provision is to enable the taxpayer to have the same basis in assets for federal and State purposes. Without this deduction provision, a taxpayer would have a different basis in the depreciable asset for State and federal purposes and would have to keep separate books and records for State and federal purposes until the disposal of the asset. In effect, the add-back and subsequent deduction will affect the timing of the impact of bonus depreciation on the State but it will not increase or decrease the total amount of revenue the State receives over the affected years.

³ The placed-in-service date is extended one year, through December 31, 2009, for property with a recovery period of 10 years or longer, for transportation property, and for certain aircraft.

Increased Section 179 Expensing Limits - In general, a qualifying taxpayer may elect to treat the cost of certain property as an expense and deduct it in the year the property is placed in service instead of depreciating it over several years. This property is frequently referred to as section 179 property, after the relevant section in the Internal Revenue Code. To be eligible, the property must be tangible personal property which is actively used in the taxpayer's business for which a depreciation deduction would be allowed. The property must be used more than 50% for business and must be newly purchased property. Generally, taxpayers take expensing first and claim section 168(k) depreciation on any remaining basis.

Last year, Congress increased the annual expensing limitation to \$125,000 with a phase-out beginning at \$500,000. Both of these limitations are indexed for inflation. Thus, prior to the ESA, the deduction was limited to \$128,000 of the cost of the property with a phase-out at \$510,000 for 2008. Because the deduction is completely phased out for qualifying purchases exceeding \$638,000, the deduction is confined generally to the relatively small business.

The new law temporarily doubles the limitation to \$250,000.⁴ The threshold for reducing the deduction is also increased to \$800,000 with a complete phase-out once qualifying purchases exceed \$1.05 million. These limitations apply only to property purchased and placed in service in tax years beginning in 2008. The limitations will return to the lower levels for tax years beginning in 2009.

► **BILL ANALYSIS:** The bill conforms to the increased expensing limit.

Increased Depreciation Limits for "Luxury" Autos. – Since the new law permits taxpayers to claim bonus depreciation, it also increases section 280F depreciation limits on luxury vehicles.⁵ A luxury vehicle is one that costs more than the "luxury auto price floor," which is adjusted annually for inflation along with the depreciation limits. The first-year limit on depreciation for passenger vehicles placed in service in 2008 is projected to be \$2,960 for automobiles and \$3,160 for vans and trucks. The new law raises the cap by \$8,000 for a maximum first-year depreciation of \$10,960 for autos and \$11,160 for vans and trucks.

► **BILL ANALYSIS:** The bill conforms to this provision.

Mortgage Forgiveness Debt Relief Act of 2007 (P.L. 110-142)

Enacted on December 20, 2007, the Mortgage Forgiveness Debt Relief Act was Congress's response to the problems generated by the subprime crisis, short sales, and rising foreclosure rates.

Income Exclusion for Discharged Indebtedness on Principal Residence. - When a lender forecloses on property, sells the home for less than the borrower's outstanding mortgage and forgives all or part of the unpaid mortgage debt, the canceled debt is considered income under the Code. This act provides an exclusion from income for this discharged indebtedness related to a principal residence for the three-year period beginning January 1, 2007 and ending December 31, 2009. There is no income limitation but no more than \$2 million in mortgage debt is eligible for exclusion.

Extension of Deduction for Mortgage Insurance Premiums. - The act temporarily extends for three years, through tax year 2010, the deduction for qualified mortgage insurance premiums. Qualified mortgage insurance is mortgage insurance provided by the Veterans Administration, the Federal Housing Administration, the Rural Housing Administration, or private mortgage insurance.

⁴ The new law does not alter the section 179 limitation imposed on sport utility vehicles, which have an expense limit of \$25,000.

⁵ These limits were increased when bonus depreciation was previously available.

Surviving Spouse Home Sale Exclusion. – The new law extends the period of time during which a surviving spouse may use the joint return filers' \$500,000 home sale gain exclusion before being treated as a single individual, who is entitled only to a \$250,000. Previously, a surviving spouse was entitled to the \$500,000 exclusion only to the extent he or she could file a joint return with the deceased spouse's estate, which only occurs for the tax year in which the spouse dies. Starting January 1, 2008, the sale of a residence that had been jointly owned and occupied by the surviving and deceased spouse is entitled to the \$500,000 gain exclusion provided the sale occurs no later than two years after the date of death of the individual spouse.

Income Exclusion for Volunteer Emergency Responders. – The act also allows volunteer emergency responders to exclude from income state and local tax benefits of up to \$360 for tax years beginning after December 31, 2007. The benefit expires in 2010. Last year, the General Assembly established a \$250 income tax deduction for certain volunteer emergency responders who attend at least 36 hours of annual training.

► ***BILL ANALYSIS:*** The bill conforms to the provisions of this act.

Small Business and Work Opportunity Tax Act of 2007 (P.L. 110-28)

Enacted on May 25, 2007, the Small Business and Work Opportunity Act of 2007 (SBWOA) was part of the larger U.S. Troop Readiness, Veterans' Care, Katrina Recovery, and Iraq Accountability Appropriations Act of 2007. It includes nearly \$5 billion in tax incentives primarily for small businesses to help businesses absorb the cost of complying with the increase in the federal minimum wage as well as a package of S corporation reforms. It includes the following provisions:

Increased Small Business Expensing Limit – The dollar and investment limitations for expensing were increased retroactively to January 1, 2007, and were extended through 2010. The prior base limit of \$100,000 was increased to \$125,000 and the investment limitation was increased from \$450,000 to \$500,000 for tax years beginning in 2007. Both limits are indexed for inflation. However, this provision is effectively superseded by the newly increased expensing provision in the ESA.

Extension of Work Opportunity Tax Credit – Created in 1996 by the Small Business Job Protection Act, this tax credit is designed to encourage employers to hire individuals from economically-challenged populations. There are nine "target" groups, including public assistance recipients, ex-felons, veterans, high-risk youth, individuals who reside in certain economically depressed areas, and individuals referred to the employer as part of a vocational rehabilitation plan. The amount of the credit is a percentage of qualified wages paid during each of the first two years of employment. Prior to this act, the credit was scheduled to expire for employees hired after December 31, 2007.

This act extends the sunset for three and a half years, until August 31, 2011, and expands the scope of the credit. It expands the targeted veterans' population to include veterans with service-connected disabilities who have been unemployed for six months or more during a one-year period ending on the hire date and are hired within one year after having been discharged from the military or released from active duty. It also increases from \$6,000 to \$12,000 in the case of individuals who qualify under the newly expanded veterans' group. The high-risk youth and vocational rehabilitation referral groups are also expanded.

Family Business Tax Simplification – Effective for tax years beginning on and after December 31, 2006, the act allows a married couple who jointly operates an unincorporated business and who files a joint return to elect not to be treated as a partnership for federal tax purposes.

Katrina Recovery Tax Incentives. – The act also extends and enhances some of the tax incentives in the Gulf Opportunity Zone Act of 2005 and Katrina Emergency Tax Relief Act of 2005. These include the extension of special expensing for qualified property, an enhanced low-income housing credit, and flexible tax-exempt bond financing rules.

S Corporation Changes – Generally speaking, these provisions are designed to make it easier for small business to retain S corp status. They also encourage use of the S corp business entity by effectively reducing the taxes owed by shareholders.

1. Passive investment income. – An S corporation that has accumulated C corporation earnings and profits and has gross receipts of which more than 25% are passive investment income may lose its Subchapter S status and will be subject to a tax on the excess passive investment income. Effective for tax years beginning after May 25, 2007, capital gain from the sale or exchange of stock or securities is no longer treated as an item of passive investment income. These gains are still counted as gross receipts but not as passive investment income.
2. Banks as S corps. - Effective for tax years beginning after December 31, 2006, the new law eliminates the treatment of restricted bank director stock as outstanding stock that threatened S corp status under the single-class-of-stock rule. It also alters the treatment of accounting adjustments caused by a bank changing its method of accounting.
3. Partial sale of QSubs. – A qualified Subchapter S subsidiary (QSub) is a wholly owned subsidiary that an S corp elects to treat as a QSub. Under the new law, a sale of QSub stock that terminates the QSub election and creates a deemed new corporation is now treated as a sale of an undivided interest in the assets of the QSub. This treatment eliminates the danger of an avalanche of gain being recognized by a sale of only a partial, but substantial (i.e. more than 20%), interest in the subsidiary.
4. ESBT interest. – Effective for tax years beginning after December 31, 2006, the new law allows an electing small business trust (ESBT) to deduct interest paid on money borrowed to acquire S corporation stock. Although Treasury regulations allocated the interest to the S corporation portion of the ESBT, they did not allow a deduction.
5. E&P reduction. – Effective for tax years beginning after May 15, 2007, the new law allows a corporation that was an S corp before 1983, but was not an S corp for its first tax year that began after December 31, 1996, to eliminate its pre-1983 earnings and profits from the corporations accumulated E&P balance. This benefit had previously been available only to a corporation that was an S corp for its first taxable year after 1996. The result is that S corps to which this new provision applies may be able to reduce the amount of distributions treated as taxable dividends.

► **BILL ANALYSIS:** The bill conforms to the provisions of this act.

EFFECTIVE DATE: This bill is effective for taxable years beginning on or after January 1, 2008.